218. The evidence Professor Gilbert cites on the interesting issue of contract versus ownership is decidedly mixed. He notes (p. 15) that there are a number of large, successful organizations such as Electronic Data Systems and Andersen Consulting that provide billing and other services under contract. I believe that outsourcing of many business services is a growing, not a shrinking trend in the U.S. economy.[38] On the other hand, as Professor Gilbert observes, merger with common ownership has been selected over contractual relations in a number of instances in the telephone industry (p. 17). The evidence here is difficult to interpret because many mergers are motivated by the theory that the acquired company has been underperforming. In other words, the driving force of the merger is not the economies obtained by using ownership in place of contracts, but rather the theory that the managers of the acquiring company can create more value from the acquired company's assets. I conclude that the evidence still supports the view that most efficiencies of joint telephone product offerings can be achieved through contracts. These efficiencies should therefore not be viewed as potential benefits from permitting a dominant local carrier to control a long-distance subsidiary.

219. Professor Gilbert examines SNET as a laboratory of bundling. He confirms that SNET is a high-price long-distance carrier, charging 23 cents per minute during peak times (p. 19). By contrast, AT&T will carry the same call for 10 cents per minute. Again, low prices are not a benefit that Connecticut consumers have enjoyed as a result of SNET's involvement in long distance.

D. Professor D. John Roberts

220. Professor Roberts concludes that predatory pricing, broadly conceived, is unlikely in the long-distance business.[39] Concerns that a dominant local carrier might drive out its rivals in long distance are farfetched, in his view. In this analysis, he applies the modern theory of predatory pricing—a theory to which he was a major contributor. In place of the earlier crude analysis that concluded that predatory pricing is almost invariably irrational, the modern theory has

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[38] See "Brand-Name Knowledge," *Wall Street Journal*, October 13, 1997, p. A22, by Robert Reich, for an interesting discussion of Sara Lee's decision to become an assetless company that outsources all business functions except managing its brand name.

[39] "Affidavit of D. John Roberts," August 18, 1997.

identified circumstances where it could occur and would actually be beneficial to the predator.

221. I concur with Professor Roberts's conclusion that a local carrier is unlikely to drive an established long-distance carrier permanently out of the market. Whatever effect occurred in the short run, the local carrier could not disable an established long-distance carrier sufficiently to prevent its re-entry later, when the local carrier raised long-distance prices. Although, as I have explained earlier in this declaration, the local carrier has powerful methods for interfering with its long-distance rivals, it can deploy these methods just as effectively without sacrificing profits by setting low long-distance prices.

222. There is evidence in favor of Professor Roberts's view that he does not cite: Dominant local carriers have invariably proven to be high-price, not low-price, entrants to long distance, and to retain high prices in local toll when entry occurs. Rather than benefiting consumers by setting low prices, they position themselves at the top of toll-call pricing.

223. Concerns about strategic anti-competitive pricing may be a serious factor in limiting local competition, a topic Professor Roberts does not consider. If the dominant local carrier develops a reputation for setting selective low prices targeted directly against local entrants, the result could be a powerful barrier to entry.

E. Professor Glenn A. Woroch

224. As Professor Woroch explains, there is—on paper—a set of provisions intended to permit rivals to offer competing local service by reselling the incumbent's service or by leasing network elements. [40] But the entire history of the regulated telephone industry shows over and over that provisions that try to overcome strong incentives are not nearly as effective as they appear on paper. The dominant local carrier has extremely strong incentives not to cooperate with local rivals. The high level of cooperation needed to make local competition effective is a tremendous challenge and will take much more than provisions on paper. Moreover, the incumbent local carriers have launched an effective

[40] "Affidavit of Glenn A. Woroch," September 29, 1997.

campaign to subvert the provisions that Professor Woroch analyzes, as their successful efforts to inhibit uniform TELRIC pricing have demonstrated.

F. The WEFA Group

225. The WEFA group has carried out a study of the effect of BellSouth control over a long-distance subsidiary serving BellSouth's own customers.[41] The study suggests that there are substantial economic benefits from that control in comparison to reliance on competition among carriers not controlled by BellSouth. The study assumes, implicitly, that BellSouth will create a new long-distance subsidiary under its control, though I understand that some of the Bells propose to enter by reselling long-distance service of existing carriers, so the primary issue appears to be the Bell's control. In summary, WEFA concludes the following about the comparison: long-distance prices would fall by 5 percent per year over the next 5 years, productivity gains in the use of information services would rise by two percent per year over the same period, and labor participation rates would rise by 0.5 percent over the next 10 years because of the increased use of telecommuting.

226. WEFA's evidence about long-distance prices is defective and does not support the proposition that the creation of a long-distance subsidiary serving South Carolina customers under the control of BellSouth would result in anything like a 25 percent cumulative effect on prices. The study uses the same faulty measures of price—standard prices and the CPI—as the other BellSouth experts. As I explained in Part IV, the actual prices customers pay for long-distance services have declined dramatically, especially recently, and can be expected to decline even more in the near future, as both access charges and other costs continue to decline and productivity continues to rise. The data in Figures 2 and 3 of the WEFA study suggesting price *increases* are completely out of touch with reality.

227. WEFA's implicit analysis is that prices have risen while costs have declined—a symptom of lessening competition—and that the creation of a long-distance reseller under BellSouth's control would jolt the market into full

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[41] The WEFA Group, "The Economic Impact of BellSouth's Entry into InterLATA Long Distance Markets in South Carolina," March 1997.

competition. In fact, prices have fallen dramatically as costs have fallen. As Part IV showed, long distance shows all the signs of being a workably competitive industry. Furthermore, the evidence I reviewed earlier about SNET's role in its long-distance market hardly support the proposition that a local carrier will push prices downward by offering customers bargains. Rather, local telephone companies tend to price their products at the high end in all the markets they participate in, including long distance where permitted. WEFA's projection of a 25 percent effect of BellSouth's control over a long-distance subsidiary finds no support either in economic theory nor in the actual performance of telephone markets.

228. According to WEFA, productivity in the use of information services will improve as a result of the proposed change in long distance.[42] But their discussion of the sources of this improvement focuses exclusively on the Internet. It is likely, in my opinion, that the Internet will add to productivity as it matures. But the Internet has little to do with long-distance telephone service of the type that would be offered by BellSouth's proposed subsidiary. Essentially all access to the Internet is through the local network. The efficiency of the Internet derives from its use of broadband packet switching. The transport of Internet messages and files over long distances is already handled in a cheap and efficient way. It would be an overstatement for WEFA to suggest that BellSouth could make significant improvements in that area, and, in fact, the study does not make that claim. WEFA makes only vague assertions that the proposed role of BellSouth in long distance will increase productivity in the usage of information services by 2 percent per year. Nowhere does the study explain how productivity will be enhanced.

229. The controversial issue today with respect to the telephone system and the Internet is in local access. The Internet has expanded rapidly under a regime of zero access charges to users. Because access does involve costs, the efficient access charge is not zero, but a level reflecting cost. But, the Bells' record hardly supports the conclusion that they are encouraging more rapid penetration of Internet usage. The Bells have failed to redesign their networks to permit highly efficient access. According to Paul Misener, manager of telecommunications at

[42] *Ibid.*, pp. 11-14.

Intel, "Rather than meeting the demand for Internet access, the phone companies want to suppress it by applying a surcharge."[43]

230. WEFA's third conclusion is that increased competition in the long-distance market will lead to increased telecommuting which will lead, in turn, to a 0.5 percent increase in the labor participation rate.[44] Yet, the benefits to telecommuting that WEFA attributes to competition in the long-distance market will most likely arise from increased competition in the local and intraLATA markets. As in Internet access, most telecommuting involves local and intraLATA telephone calls. The interchange of computer data for telecommuting takes place over packet-switched networks, not through regular long-distance service of the type that BellSouth proposes to resell.

231. In my opinion, the WEFA Study has no scientific value. Nothing in the study helps us understand how the price of long distance would be affected by BellSouth's creation of a long-distance subsidiary. And the study makes laughable errors in attributing improvements in productivity in areas where long-distance service in fact plays no role. To achieve the productivity benefits identified in the WEFA study, we need to bring more competition to local service.

VII. Conclusions

232. I can find no benefit from BellSouth's control of a long-distance subsidiary other than to BellSouth itself. The company will be able to obtain a substantial market share in South Carolina's long-distance market because of its ability to hobble its long-distance rivals. In addition, it will have the advantage of facing the true cost of access, which is less than the access charge paid by its rivals, though, as I explained earlier, this advantage is tempered by the opportunity cost when BellSouth takes a call away from a rival who depends on BellSouth for access. The result will be a reduction in competition in long distance and higher

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[43] "Access Providers, Baby Bells Fighting Over Internet Wealth," *The New York Times CyberTimes,* November 25, 1996.

[44] *The WEFA Study,* pp. 14 and 15.

prices to the long-distance consumer. Further, BellSouth's presence in long distance would lower incentives for entry of independent local carriers and inhibit the development of local competition. Local telephone prices would be higher as a result.

233. The Telecommunications Act relies on the principle of structural separation until there is sufficient local competition that the principle is no longer needed. This principle imposes a limitation on the Bells—that there may be no joint operation of local and long-distance service. I believe that the principle of structural separation is a sound one under current and near-future conditions, from the point of view of the welfare of the U.S. consumer. Structural separation does *not* reduce the number of sellers in the long-distance market. Nor does structural separation decrease consumer welfare.

234. I believe that consumers benefit from continued structural separation of local service and long distance. Contrary to BellSouth's experts' view, I believe that structural separation remains a valid principle for governing the telephone industry as long as there is not competition based on irreversible investment in local telephone service for all groups of customers.

235. Many discussions of the economic effects of permitting local telephone companies to control long-distance subsidiaries presume that another long-distance seller will improve competition and lower the price of long-distance services. The primary reason to be skeptical of this presumption is the evidence presented in Part IV showing the advanced degree of competition in the long-distance market. What could a local telephone company do that companies already in nationwide operation have not already done?

VIII. About the Author

236. I serve as Professor of Economics at Stanford University and also Senior Fellow at Stanford's Hoover Institution. I received a Ph.D. in economics from the Massachusetts Institute of Technology in 1967. I have been elected a fellow of the American Academy of Arts and Sciences and a fellow of the Econometric Society. I have published 7 books and numerous articles in several areas of

applied economics. I have extensive experience in the economics of telecommunications, computers, and software. Recently I served as an expert for the Department of Justice in its case against Microsoft and in its opposition to Microsoft's proposed merger with Intuit. Further information about my professional activities is in my *curriculum vitae*, which is appended to this declaration.

I declare, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.

Executed on October 19, 1997.

[signature]

Robert E. Hall

June 1997

CURRICULUM VITAE

Robert E. Hall
Hoover Institution
Stanford University
Stanford, California 94305
(415) 723-2215
Fax: 725-7320
Email: Hall@Hoover.Stanford.EDU

Born August 13, 1943, Palo Alto, California
Social Security Number: 559-60-0891

PhD in economics, MIT, 1967; BA in economics, University of California, Berkeley, 1964

Senior Fellow, Hoover Institution, and Professor, Department of Economics, Stanford University, since 1978

Previously Professor of Economics, MIT (1974-78), Associate Professor of Economics, MIT (1970-74), Acting Associate Professor of Economics, University of California, Berkeley (1969-70), Assistant Professor (1967-69)

Fellow, American Academy of Arts and Sciences
Fellow, Econometric Society

Director, Research Program on Economic Fluctuations, National Bureau of Economic Research, since 1977
Member, Advisory Committee, Congressional Budget Office, since 1993
Member, Oversight Panel for Economics, National Science Foundation, 1989, and Advisory Panel for Economics, 1970-72
Member, Yale University Council Committee on Social Sciences—Policy, 1989-94
Member or Senior Advisor, Brookings Panel on Economic Activity, since 1970
Member, President's Advisory Committee on Productivity, 1981-82

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Application of BellSouth Corporation,	)	CC Docket No. 97-231
BellSouth Telecommunications, Inc.	)	
and BellSouth Long Distance, Inc.	)	
for Provision of In-Region, InterLATA	)	
Services in Louisiana	)	

Exhibit G:
Declaration of Kenneth Baseman and Frederick Warren-Boulton
in CC Docket No. 97-208

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Application by BellSouth Corporation,	)	CC Docket No. 97-208
BellSouth Telecommunications, Inc., and	)	
BellSouth Long Distance, Inc. for	)	
Provision of In-Region, InterLATA	)	
Services in South Carolina	)	

DECLARATION OF
KENNETH C. BASEMAN AND FREDERICK R. WARREN-BOULTON
ON BEHALF OF MCI

I. INTRODUCTION

1. Frederick R. Warren-Boulton is a Principal with MiCRA (Microeconomic Consulting and Research Associates, Inc.), a Washington-based economics consulting and research firm specializing in antitrust and regulatory matters. He holds a B.A. degree from Yale University, a Master of Public Affairs from the Woodrow Wilson School of Public and International Affairs at Princeton University, and M.A. and Ph.D. degrees in Economics from Princeton University. From 1972 to 1983, he was an Assistant and then Associate Professor of Economics at Washington University in St. Louis.

2. From 1983 to 1989, Dr. Warren-Boulton served as the chief economist for the Antitrust Division of the U.S. Department of Justice, first as the Director of its Economic Policy Office and then as the Deputy Assistant Attorney General for Economic Analysis. Since leaving the Department of Justice, he has served as a Resident Scholar at the American Enterprise Institute, a Visiting Lecturer of Public and International Affairs at the Woodrow Wilson School at Princeton University, and a Research Associate Professor of Psychology at The American University.

3. Dr. Warren-Boulton's area of specialization is in the economics of industrial organization. His publications are primarily in the application of industrial organization economics to antitrust and regulation, including a number of papers that consider appropriate

public policy toward regulated industries, including telecommunications. A complete description of his background and papers can be found in his Curriculum Vitae, a copy of which is attached to this Declaration.

4. Kenneth Baseman is a Principal with MiCRA, an economic consulting firm in Washington, D.C. He received his graduate training in economics at Stanford University. He served as a senior economist in the Economic Policy Office of the Antitrust Division of the Department of Justice where, for over two years, he was a member of the Division's trial staff in U.S. v. AT&T. He has been an economic consultant for thirteen years. His consulting assignments have focused primarily on competitive issues, both in antitrust and regulatory proceedings. His earlier professional papers dealt with entry and competition in a regulated industry with natural monopoly characteristics and were published in the *American Economic Review,* and by the National Bureau of Economic Research and the MIT Press. His more recent publications have focused on the use of non-linear pricing and technical incompatibility by dominant firms to preserve market power in the face of developing competition. He has consulted on telecommunications issues with the Department of Justice, MCI, AT&T, the National Cable Television Association, and WebCel Communications. A copy of his vita is attached to this Declaration.

5. MCI has asked us to analyze the provision of interLATA service in South Carolina by BellSouth. We conclude that the provision of in-region, interLATA service by BellSouth is

premature and should not be allowed now. BellSouth's provision of interLATA service in its own territory must be linked to the level of competition in local telephone markets. BellSouth's control over bottleneck local facilities gives it the incentive and the ability to harm competition in the long-distance market and to stifle nascent competition in the local markets. Regulation will be insufficient to control such incentives and monopoly power. Consequently, only widespread, effective facilities-based local competition will prevent BellSouth from acting on its ability and incentive to harm the competitive process.

6. Any complete analysis of an RBOC's entry application must address both the benefits and the costs of such entry. Our Declaration focuses on the costs; i.e., the potential harm to competition and economic efficiency associated with BellSouth's application. In a companion Declaration, Robert Hall addresses and rebuts arguments frequently made by RBOCs, including those advanced by BellSouth's economists in this proceeding, that the long-distance industry is performing poorly and RBOC entry is needed to break up a tacitly collusive long-distance cartel. We agree with Professor Hall that significant economies of vertical integration from RBOC entry into interLATA service are very unlikely, especially given the requirements for structural separation in Section 272 of the 1996 Act. Absent any credible expected benefits from interLATA entry by the RBOCs, the FCC's entry decision should turn on whether the expected costs of interLATA entry by the RBOCs are also negligible. We find that these risks are quite substantial at this time, however, so that BellSouth should not now be allowed to offer interLATA service in South Carolina.

II. THERE ARE SIGNIFICANT SOCIAL COSTS FROM PREMATURELY ALLOWING AN RBOC TO PROVIDE INTERLATA SERVICE.

A. The linkage between allowing an RBOC to offer interLATA service and the level of competition in local telephone markets.

7. There are three distinct rationales for linking an RBOC's entry into interLATA service to the level of competition for local services. First, as long as the RBOC controls a regulated, bottleneck facility, it will have powerful incentives for anticompetitive behavior if it is allowed to participate in other markets for which access to the bottleneck is essential. This is true in particular for the long-distance market. When customers have a real choice among facilities-based local competitors, independent long-distance companies will become less dependent on the RBOC's upstream (i.e., local exchange) services, reducing the incentive for anticompetitive behavior by the RBOC and reducing the potential harm to competition in downstream markets.

8. Second, premature entry into interLATA long distance will allow the RBOC to engage in behavior that will limit the extent to which local competition can develop. Among these strategies are signing up customers for bundled local and long-distance services before local competition has had a chance to develop; the use of customer specific discounts on long-distance or bundled services in order to cut prices to local service customers most likely to patronize new local service entrants; raising the cost to customers of switching local service providers; and providing poor service when customers switch to new local carriers (thereby damaging the new

carrier's reputation and requiring it to incur additional costs to mollify their customers). These strategies can all enable the RBOC to "lock in" its control over local service customers prior to the development of effective local competition.

9. Third, regulatory approval of interLATA entry serves as a reward or "carrot" to induce the RBOCs to open up their local networks. Under the 1996 Act, they are required to unbundle their local networks and sell the components at cost-based rates. But these actions on the part of the RBOC, while legally required, are complex and difficult to monitor. It will be hard for regulators to determine if the RBOC is really complying with the Act's requirements to the best of its ability. If an RBOC receives the carrot of long-distance entry before it has opened its network in a meaningful and irreversible way, its sole business incentive to cooperate in setting reasonable terms, conditions, and operating procedures for local network access by competing local exchange carriers is eliminated.

B. An RBOC would have powerful anticompetitive incentives in the in-region, interLATA business if it were allowed to enter.

10. An RBOC's entry into in-region, interLATA long-distance service is likely to harm the competitive process and therefore make consumers of long-distance and local services worse off, unless it faces effective competition in the markets for unbundled network elements and for retail local exchange services. Until effective local competition develops at both levels, the RBOC

will continue to control bottleneck upstream facilities. Economists and policy-makers have long recognized the dangers of allowing a regulated, bottleneck monopolist to compete in related markets. Absent either enough facilities-based local entry, so that competition replaces regulation as the effective constraint in the RBOC's upstream pricing, or ideal regulation that would ensure access by others to its local facilities on equivalent terms, the RBOC will retain both the ability and incentive to discriminate against competitors in the long-distance market. With only very limited possible exceptions, however, regulators' ability to regulate access to the RBOC's facilities will necessarily be imperfect, and long-distance competitors (and their customers) cannot expect to benefit from truly nondiscriminatory access to the RBOC's facilities until effective competition appears.

11. Public policy for at least the past 15 years has recognized that allowing a regulated, bottleneck monopolist into related markets carries substantial dangers. These concerns are firmly founded in the economics literature.[1] A regulated bottleneck monopolist has a strong financial incentive to enter into and control potentially competitive related markets in order to evade the constraints that regulators attempt to place on its profits and prices at the bottleneck level. It can block competition and gain control over those related markets it is allowed to enter simply by refusing rivals access to its bottleneck facilities. Where outright denial is not allowed,

[1] See, e.g., J.A. Ordover and G. Saloner, "Predation, Monopolization and Antitrust," in The Handbook of Industrial Organization, Vol. 1, Ch. 9; R. Schmalensee and R. D. Willig eds. (North Holland) 1989.

it can be expected to attempt to provide access only on discriminatory terms. Where regulation constrains its profits in the core monopoly, an RBOC can expect that, by raising the input costs of its rivals, it could profitably increase its own price for the unregulated downstream service while suffering no offsetting loss in the constrained profits of the core monopoly. Where regulation directly constrains an RBOC's prices, but not its profits, incentives for discrimination remain pervasive because the profit gain downstream from discrimination will often outweigh any forgone profit in the core monopoly due to lost sales, and lost margins, due to discrimination against downstream rivals. Additionally, an RBOC may attempt to cross-subsidize its competitive activities with revenues from monopoly markets. This cost shifting is profitable to the extent that the RBOC is allowed to pass these costs through via higher prices to its local service customers.

C. An RBOC has strong incentives to discriminate against local telephone competitors.

12. Concerns over the RBOCs' ability and incentive to discourage local competition proceed from a different theoretical framework than the concerns described above over anticompetitive leveraging into adjacent markets. The RBOCs have continuing incentives to discriminate against local exchange competitors that are even more direct than their incentives to discriminate against rival long-distance suppliers. Indeed, there is substantial evidence that the incumbent local

exchange carriers ("ILECs") have frustrated competitive entry at every turn.[2] The RBOCs have incurred enormous sunk costs to build their local networks (albeit funded by their ratepayers). The modern economics literature on industrial organization recognizes the role that sunk costs play as barriers to entry.[3] When incumbents have sunk their costs, and entrants have not, incumbents are said to have a "first-mover" advantage.[4] First-mover advantages often turn out to be of strategic importance because the incumbent, having already sunk its costs, will have available a variety of tactics that are relatively costless to it but that can dramatically reduce the incentives of potential entrants to actually sink the costs necessary to enter. Moreover, since the value of monopoly profits will exceed the entrant's portion of industry profits, actions taken by the incumbent that appear to inflict equal costs or losses on both the entrant and incumbent will be highly profitable if, as a result, monopoly profits are preserved because entry is foreclosed or the scale of entry is reduced. This principle has been recognized by the Federal Communications

[2]See, e.g., the Michigan Public Service Commission Staff's Request for Clarification, In the Matter of the Application of City Signal, Inc. for an order establishing and approving interconnection arrangements with Michigan Bell Telephone Company, Case No. U-10647 (July 26, 1995).

[3]The sunk costs associated with entry are the costs that cannot be recovered if the entry attempt is unsuccessful. Common examples are marketing costs (to the extent, as will usually be the case, that the "brand name capital" cannot be fully transferred to other markets), facilities costs (to the extent that full value of the equipment, less normal depreciation, cannot be recovered in a used equipment market), and any costs incurred to compensate customers for the costs they incur in switching suppliers. For a discussion of the relation between sunk costs and barriers or impediments, see Jean Tirole, *The Theory of Industrial Organization*, Chapter 8, The MIT Press (1989).

[4]First-mover advantages are not simply the product of being first. If sunk costs are not necessary for entry, no first-mover advantage exists.

Commission: "The economic principle at work . . . is that a monopolist stands to lose more profits than a duopolist has to gain; thus, the monopolist has a greater incentive to preempt than an entrant has to enter."[5]

13. Examples of potentially exclusionary tactics include:

a) Strategic use of long term contracts. Incumbents faced with potential entry have incentives to sign up customers for long term contracts and to stagger the terms of those contracts. Simply "locking in" customers with long term contracts pushes the threat of entry off into the future, since the size of the entrant's potential market is smaller. This, in turn, reduces the financial feasibility of entry. Staggering the contract lengths imposes a permanent cost penalty on entrants, since the potential market available to the entrant will be smaller in all periods.[6] Discounts that induce exclusive dealing (where customers deal with only one seller for a product) or contracts with high withdrawal penalties can have the same "lock-in" effect.[7]

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[5]Federal Communications Commission, Second Report and Order, Order on Reconsideration, and Fifth Notice of Proposed Rulemaking, CC Docket No. 92-297, Rulemaking to Amend Parts 1, 2, 21, and 25 of the Commission's Rules to Redesignate the 27.5-29.5 Ghz Band, to Reallocate the 29.5-30.0 Ghz Frequency Band, to Establish Rules and Policies for Local Multipoint Distribution Service and for Fixed Satellite Services at 76-77 (March 11, 1997).

[6]The long-distance industry now features a variety of calling and promotional plans. For businesses, concessions and promotional terms are often individually negotiated (even though the pricing plans themselves are offered on a nationwide basis). Thus simply by engaging in what is normal business practice in the long-distance business, an RBOC will be able to offer customer-specific discounts to local service customers most likely to patronize a new entrant. The discounts are pro-competitive in long distance, where facilities-based competition is well established. However, such discounts can discourage facilities-based entry for local service when employed by an incumbent who is just beginning to face competition.

[7]The consent decree between the U.S. Department of Justice and Microsoft requires that Microsoft remove from its contracts with computer manufacturers a particular discount structure that induced exclusive dealing. The decree also requires Microsoft to shorten the length of its contracts.

b) Poor service to new entrants. Providing poor service in provisioning network elements when switching a customer to a new local carrier raises the costs of entry, since the entrant will be forced to increase promotional and marketing expense to offset, as best it can, the adverse effects of the RBOC's poor performance on its own reputation.

c) Artificially raising the costs of switching between local carriers. Since the incumbent RBOC starts with all the local customers, policies that uniformly raise customer switching costs, such as setting artificially high nonrecurring charges for service ordering or line connection for unbundled network elements (UNEs), protect the incumbent's customer base and raise the costs of entry.[8]

d) Discriminatory access to customer information. For example, a local entrant who relies in part on UNEs must provide to the RBOC competitively sensitive information, such as the identity of customers who are considering switching to them from the RBOC. The RBOC then has incentives to target marketing resources to those customers to try to prevent the switch. The entrant has no such information when one of its customers is contemplating a switch back to the RBOC.[9]

e) Pricing of and access to UNEs. Access to unbundled network elements is key to many new entrants. Clearly, however, it is not in the RBOC's interest to assist its direct competitors. If unbundled elements are priced well above economic cost, or if the procedures for purchase of unbundled

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[8]The ILECs' behavior in the intraLATA business provides a good analogy. When intraLATA competition has been allowed, several ILECs have instituted PIC freezes. A PIC freeze is a cessation of the customary practice whereby the LEC will change a customer's presubscribed interLATA (or intraLATA) carrier based on a request from that carrier authorized by the customer. When a freeze is in effect, a change in long-distance carrier cannot be implemented until the customer directly and personally provides authorization for the change to the ILEC. This raises the cost of customer switching, which is an advantage for an incumbent who begins with all or almost all the customers. PIC freezes can give the ILEC an advantage in competing for customers who prefer purchasing bundled local and long-distance service. The IXCs don't know which customers have signed up for the freezes, so they waste marketing costs reaching those customers. If the ILEC's long-distance affiliate knows which customers are more expensive to switch (because they have signed up for the freeze), then it is better able than its rivals to efficiently utilize its marketing resources.

[9]MCI has filed complaints against PacBell and SNET for precisely this type of behavior.

elements simply don't work very well, then entry barriers are higher than with cost-based pricing under a well-functioning set of purchase procedures. It is our understanding that the final pricing of UNEs is still not established in many states. Uncertainty over the pricing for major inputs can only inhibit entry.[10] In addition, it is also our understanding that there has only been very limited and unsatisfactory experience with how well the ordering, provisioning, and maintenance processes for UNEs under the arbitration agreements will work in practice. Slow, cumbersome, expensive, or unreliable processes can all impede or delay entry.

D. The "carrot" rationale for linking an RBOC's interLATA authority to the state of local competition.

14. Two local telephone markets are relevant to these proceedings: the downstream, retail market, where telecommunications services are sold to final customers, potentially by a large number of suppliers, and the upstream market for unbundled network elements ("UNEs"), where inputs are sold to providers of retail telecommunications services.

15. Because an RBOC's natural business incentive is to restrict and delay local entry, it makes sense to offer the RBOC both carrots and sticks depending on how local competition (which depends in large part on the RBOC's behavior) develops. One carrot is interLATA entry, which the RBOCs have coveted for some time. But since local competition depends on the degree to which an RBOC makes UNEs fully and generally available on reasonable terms, and the extent to which interconnections between local networks work in practice, it would be a

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[10]See Avinash Dixit and Robert Pindyck, *Investment Under Uncertainty*, Princeton University Press (1994).